

SUMMARY ANALYSIS OF AMENDED BILL

Author: Frommer Analyst: Gail Hall Bill Number: AB 1037
Related Bills: See Legislative History Telephone: 845-6111 Amended Date: August 7, 2006
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Net Receipts In Sales Factor For Treasury Function/Quadruple Weighted Sales Factor For Qualified Business Activity

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as amended June 12, 2006.

X FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO _____.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED _____ STILL APPLIES.

X OTHER – See comments below.

SUMMARY

Under the Corporation Tax Law, this bill would do the following:

- Define gross receipts.
- Change the method used by companies in specified industries to calculate their California business income.

SUMMARY OF PROPOSED AMENDMENTS

The amendments made the following revisions to the bill:

- Removed the phase-in of a single sales factor.
- Added a quadruple-weighted sales factor for specified industries.

Board Position:	____ NA	____ NP	Department Director	Date
____ S	____ O	____ NAR		
____ SA	____ OUA	<u>X</u> PENDING	Brian Putler	8/9/06
____ N				

- Added a sunset date for the provisions added by the bill relating to the apportionment of business income.
- Removed an extractive business activity from the definition of a qualified business activity and provided new apportionment rules.
- Added a provision that tangible personal property for sales factor purposes shall include prewritten software for a qualified taxpayer electing the quadruple-weighted sales factor.
- Added nine industries (see Appendix A) and removed the cable and other program distribution industry that may elect quadruple-weighted sales if the \$1 billion requirement is met.
- Resolved implementation consideration 2 in the analysis of the bill as amended September 8, 2005, by referencing the Principal Business Activity Codes (PBAC) prescribed by the Internal Revenue Service (IRS) on December 31, 2005.

PURPOSE OF THE BILL

The author's office has indicated the purpose of this bill is to define a previously undefined term to prevent potential manipulation of the franchise tax apportionment formula and to encourage certain industries to invest in California.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. This bill provides that the amendments relating to the treasury function¹ would become operative for taxable years beginning on or after January 1, 2006, and the amendments relating to the apportionment formula weighting² would become operative for taxable years beginning on or after January 1, 2007, and before January 1, 2010.

POSITION

Pending.

ANALYSIS

Federal Law

The issues discussed in this bill are not applicable to federal law because the federal method of income taxation is different from the California method.

¹ Revenue and Taxation Code (R&TC) Section 25120.

² R&TC Section 25128.

State Law

Apportionment

California has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with certain modifications, to determine how much of a taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise [or income] tax. UDITPA uses an apportionment formula to determine the amount of "business" income attributable to California³.

The apportionment formula consists of property, payroll, and sales factors. The property factor includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; the sales factor is double weighted and generally includes all gross receipts from the sale of tangible and intangible property.

The calculation of the apportionment formula and California business income is illustrated below.

$$\begin{array}{c} \text{Average} \\ \text{CA Property} \\ \hline \text{Average Total} \\ \text{Property} \\ \text{Everywhere} \end{array} + \begin{array}{c} \text{CA Payroll} \\ \hline \text{Total Payroll} \\ \text{Everywhere} \end{array} + (2 \times \begin{array}{c} \text{CA Sales} \\ \hline \text{Total Sales} \\ \text{Everywhere} \end{array}) = \text{California Apportionment}$$

Formula

$$\frac{\text{California Apportionment}}{4} \times \text{Total Business Income} = \text{California Business Income}$$

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor apportionment formula consisting of property, payroll, and double-weighted sales (three-factor, double-weighted sales). An exception to this rule is taxpayers that derive more than 50 percent of their gross business receipts from conducting a "qualified business activity," such taxpayers use a three-factor, single-weighted sales apportionment formula. A qualified business activity is defined as an agricultural, extractive, savings and loan, and banking or financial business activity.

Current law provides that if the individual corporations included in a combined report (combined group tax return) meet different requirements for weighting their sales factor, the weighting of the sales factor used by the member with the predominant gross business receipts in the combined report must also be used by the other members of the combined report. For example,

³"Business income attributable to California" is a taxpayer's "business income" multiplied by its California apportionment formula. Revenue & Taxation Code (R&TC) Section 25120(a) defines "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." R&TC Section 25210(d) defines "nonbusiness income" as all income other than business income. In general "business income" is income arising in the normal course of the taxpayer's or from assets used in the normal course of the taxpayer's business.

if Corp A and Corp B are members of a combined report, and Corp A's activities are of a nature that they would use a single-weighted sales factor and Corp B's activities are of a nature that they would use a double-weighted sales factor, if Corp B is predominant (more than 50%), then Corp A must instead use a double-weighted sales factor when calculating its apportionment percentage. If Corp A's activities were predominant a single-weighted sales would be used by all members of the combined report group⁴

State law permits a departure from the standard apportionment provisions only in limited and specific cases⁵ and recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions and provide special apportionment procedures for those situations.⁶

Sales Factor

The sales factor is defined as a taxpayer's total California sales divided by a taxpayer's total sales everywhere.⁷ Sales are defined as all gross receipts of the taxpayer except for certain nonbusiness income.⁸ California law does not provide a definition for gross receipts.

Sales of all items other than tangible personal property are categorized as California sales if the income producing activity related to the sale is performed in California, or if the income producing activity is performed in more than one state, the greater proportion of the activity, as determined by cost, is performed in California.⁹ In the past, the department has taken the position that canned or prewritten software should be treated as tangible personal property for sales factor purposes.

THIS BILL

Treasury Function

This bill would limit gross receipts from a treasury function activity to the overall net gain for the calculation of the California sales factor. This bill provides the following definitions:

1. "Treasury function" means the pooling, management, and investment of liquid assets and provides that income arising from the treasury function shall be classified as business income. The treasury function definition specifically excludes hedging activities relating to the business of the taxpayer. For example, if a taxpayer makes a product using wheat, and the taxpayer participates in hedging activities to reduce the risk of cost fluctuations of its wheat inventories (raw materials), these hedging activities would not be included in the definition of treasury function activities, and therefore, the receipts from these hedging activities would be included in the sales factor at "gross receipts" instead of "net gain."

⁴ California Code of Regulations (CCR), title 18, Section 25106.5(c)(7)(A).

⁵ R&TC Section 25137.

⁶ CCR, title 18, Section 25137.

⁷ R&TC Section 25134.

⁸ R&TC Section 25120(e).

⁹ R&TC Section 25136.

2. "Liquid asset" means a readily marketable intangible. Examples are stocks, bonds, debentures, options, warrants, futures contracts, foreign currency, and mutual funds that hold those intangibles. An intangible is considered marketable if it is traded in an established stock or securities exchange or market and is regularly quoted by brokers or dealers.

In addition, this bill provides that a broker-dealer registered with the Securities and Exchange Commission or equivalent federal agency would not include its regular business activities in the definition of liquid assets.

Sales Factor

This bill would add a new R&TC Section 25128 that would be operative for taxable years beginning on or after January 1, 2007, and before January 1, 2010. The new Section 25128 would allow certain taxpayers to elect to use a three-factor, quadruple-weighted sales apportionment formula. In addition, certain taxpayers would be permitted to use a three-factor, single-weighted sales apportionment formula. This bill would add the following provisions to the current rules on the apportionment of business income:

1. A "qualified taxpayer" may elect to apportion business income using a three-factor, quadruple-weighted sales apportionment formula. A qualified taxpayer is defined as an apportioning trade or business that derives more than 50 percent of its gross business receipts from conducting a business activity, or combination of activities, described in specified federal PBACs. (See Appendix A.) This election may be made on a year-to-year basis.

In addition, a qualified taxpayer that elects to apportion business income using a three-factor, quadruple-weighted sales apportionment formula shall treat prewritten software as tangible personal property for sales factor purposes, regardless of the method of delivery.

2. An apportioning trade or business may elect to use a three-factor, quadruple-weighted apportionment formula if the taxpayer derives more than \$1 billion of gross business receipts from conducting a business activity or a combination of activities described in specific PBACs. (See Appendix A.) The \$1 billion test takes into consideration the gross business receipts of all members of the apportioning trade or business that are engaged in one or more qualified business activities. The \$1 billion requirement must only be met in the year the apportioning trade or business makes the election.

The bill would apply a special apportionment rule to determine the business income for each taxpayer that meets the \$1 billion requirement and uses a different apportionment formula (i.e., double-weighted sales versus quadruple-weighted sales) for entities that are included in the same combined report as the qualifying taxpayers but are not involved in a qualifying business activity.

3. An apportioning trade or business that derives more than 50 percent of its gross business receipts from conducting a business activity or combination of activities described in specific PBACs (See Appendix A) may elect to use a three-factor, double-weighted sales apportionment formula. In the alternative, the taxpayer may elect a three-factor, single-

weighted apportionment formula. The more than 50 percent requirement must only be met in the year the apportioning trade or business makes the election.

In addition, this bill would provide that sales arising from a treasury function of a taxpayer's trade or business would be excluded from the calculation of gross business receipts. This bill would define "gross business receipts" as all gross receipts of the taxpayer including nonbusiness income allocated to the state. Sales excluded from gross receipts due to the application of Section 25137 would still be included as gross receipts in the calculation of the 50% threshold.

Other Apportionment Formulas

1. This bill would remove an extractive business activity from the definition of a qualified business activity. Under current law, a qualified business activity is required to use a three-factor, single-weighted sales apportionment formula. This bill would allow an extractive business to elect either a three-factor, quadruple-weighted sales apportionment formula, or a three-factor, single-weighted apportionment formula. If no election is made, the extractive business would use the three-factor, double-weighted sales apportionment formula.

This bill would provide that if an apportioning trade or business is neither a qualified taxpayer nor meets requirements to elect to use a single-weighted or a quadruple weighted sales factor, the taxpayer would use a double-weighted sales apportionment formula.

Elections

The bill provides for the following three elections:

1. A qualified taxpayer may elect to apportion income using a three-factor quadruple-weighted sales apportionment formula in a form and manner prescribed by the Franchise Tax Board (FTB). This election may be made on a year-to-year basis.
2. A taxpayer meeting the \$1 billion requirement may elect to apportion income using a three-factor quadruple-weighted sales apportionment formula by contract with FTB on a timely filed original return. This election is specified to be a one-time binding election.
3. An apportioning trade or business that derives more than 50 percent of gross business receipts from specified industries may elect to use a three-factor quadruple-weighted sales apportionment formula or a three-factor single-weighted sales formula by contract with FTB on a timely filed original return. This election is specified to be a one-time binding election.

These elections may be terminated by the taxpayer if either of the following occurs:

- The taxpayer is acquired, directly or indirectly, by a nonelecting entity that alone, or together with the members of its group return, is larger than the taxpayer as measured by equity capital. Equity capital is defined as stock of any class, paid-in capital and retained earnings, or earned surplus, as set forth

in the balance sheet of the taxpayer or nonelecting entity, for the immediately preceding year-end accounting period.

- The taxpayer obtains permission from the FTB.
- This bill would provide that if any portion of this section is held invalid, the other provisions of the section that can be reasonably separated shall remain in effect.

This bill would provide that it is the intent of the Legislature that provisions of the bill that revise the apportionment formulas are not intended to modify the sales factor portions of any special apportionment formulas found in regulations under Section 25137.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. An equity interest in a business entity that is unitary with the taxpayer, such as stock in a corporation, could be interpreted to meet the definition of a liquid asset and be classified as a marketable intangible even though the equity interest is not part of the treasury function. This may cause confusion for taxpayers and the department.
2. The bill provides a new apportionment rule for a taxpayer and members of the group tax return where that taxpayer elects to use the quadruple-weighted sales factor under the \$1 billion requirement and there are members of the group that may not elect to use the quadruple-weighted sales factor. Current law already provides rules that could apply to members of a group tax return with different weighted sales factors that may provide simplicity.
3. Further amendments are recommended to clarify the nexus rule that is intended to apply when a taxpayer sells prewritten software that is never reduced to a tangible form (e.g., download of software from the Internet). Likewise, amendments are recommended to eliminate destination issues such as to the ultimate destination and whether the customer billing address should be used.
4. It may be necessary to add "notwithstanding Section 38006" language to the proposed amendments relating to prewritten software. Without this language, in-state companies could assign outbound sales of prewritten software to other states and out-of-state companies could make a multistate tax compact¹⁰ election and assign inbound sales of prewritten software also to other states resulting in zero sales assigned to California for purposes of the sales factor.

¹⁰ The Multistate Tax Compact (R&TC Section 38006) is an agreement among participating states to facilitate the uniform administration of state taxes for multistate taxpayers. Taxpayers in participating states may use the current state laws or elect the provisions of the law in the multistate tax compact under Section 38006.

5. It is unclear if the election relating to a qualified taxpayer and prewritten software is a year-to-year, transaction-to-transaction, or a binding election. In addition, while the treatment of prewritten software as tangible personal property is consistent with current departmental practice, the department has not taken a formal position regarding whether the method of delivery impacts this determination.

TECHNICAL CONSIDERATIONS

1. The reference to "Section 38006" should be expanded to provide that it is located in Part 18. See attached Amendment 1.
2. The definition of the "treasury function" should be restored to the amendments in the bill as amended April 7 and 12, 2005. This would resolve issue number one found in the LEGAL IMPACT portion of this analysis below. See attached Amendment 2.
3. To ensure that the amendments made by the bill include comprehensive definitions for treasury function activities, language should be added to include repurchase arrangements in the definition of a "liquid asset" because those transactions may be a significant activity of the treasury function. See attached Amendment 3.
4. Two of the binding elections found in the bill would require the election to be made by contract. This is inconsistent with the other election found in the bill and may result in substantial performance issues as found with the repealed water's-edge contract provisions that were replaced with binding election rules. It is recommended the reference "shall be made by contract with the Franchise Tax Board" be deleted. This change would make the election statutory instead of contractual. See attached Amendments 4 and 5.

LEGISLATIVE HISTORY

AB 2590 (Campbell, 2003/2004) and AB 2560 (Vargas, 2001/2002) would have replaced the three-factor, double-weighted sales apportionment formula used by most corporations with a single-factor apportionment formula based solely on sales. Exceptions to using the single-factor formula would have included: 1) taxpayers that had an average of property and payroll in California in excess of sales that did not meet certain employment requirements would use the three-factor, double-weighted sales formula, and 2) taxpayers that derive more than 50 percent of their gross business receipts from extractive activities could have used either the single-factor sales formula or the three-factor, single-weighted sales formula. AB 2590 and 2560 were held in Assembly Appropriations.

AB 1642 (Harmon, 2001/2002) and SB 1014 (Johnson, 2001/2002) would have changed the apportionment formula used to determine the amount of business income taxable by California to a single-factor apportionment formula based on sales and allowed extractive businesses to choose either the current three-factor formula based on property, payroll, and sales, or use the new single-factor formula. AB 1642 died pursuant to Article IV, Section 10(c) of the Constitution; SB 1014 was returned to Secretary of Senate pursuant to Joint Rule 56.

OTHER STATES' INFORMATION

The states surveyed relating to the treasury function and sales factor include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Sales Factor

General research was performed to determine how these other states "weight" the sales factor in their apportionment formula.

Florida and *Massachusetts* generally use a double-weighted sales factor with some exceptions for specialized industries.

Illinois began using the single sales factor for tax years ending on or after December 31, 2000. The single sales factor formula is used by corporations deriving business income from the state, rather than being determined by a corporation's PBAC(s).

Michigan's apportionment formula consists of 5 percent payroll, 5 percent property, and 90 percent sales.

Minnesota's apportionment formula consists of 12.5 percent property, 12.5 percent payroll, and 75 percent sales.

New York utilizes a business allocation formula to assign business income to *New York*. For tax year 2006, *New York* will begin the process of phasing in a new, single-factor allocation formula based on in-state receipts. The single-factor allocation formula will be phased-in as follows: 1) for tax year 2006, the business allocation formula will be equal to 20 percent property, 60 percent sales, and 20 percent payroll; 2) for tax year 2007, the business allocation formula will be equal to 10 percent property, 80 percent sales, and 10 percent payroll; and 3) for tax years beginning on or after January 1, 2008, the business allocation formula will consist of 100 percent sales.

Treasury Function

General research was performed to determine how these states define "gross receipts." *Minnesota, Michigan, Massachusetts, New York, and Florida* exclude treasury transactions in the definition of "gross receipts," and *Illinois* includes the net gains from treasury transactions in "gross receipts."

Florida – The term "sales" means all gross receipts received by the taxpayer from transactions and activities in the regular course of its trade or business, except interest, dividends, rents, royalties, and gross receipts from the sale, exchange, maturity, redemption, or other disposition of securities.

Illinois – Gross receipts from the sales of business intangibles, such as patents, copyrights, bonds, stocks, and other securities, are disregarded, and only the net gains or losses are included in the sales factor.

Massachusetts – The sales factor is a fraction, the numerator of which is the total sales of the corporation in that Commonwealth during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. As used in that law, “sales” means all gross receipts of the corporation except interest, dividends, and gross receipts from the maturity, redemption, sale, exchange, or other disposition of securities.

Michigan – “Sales” includes gross receipts from the sales of tangible property, from the rental of property and from providing services provided as part of the taxpayer’s business activity (such as legal or accounting services).

Minnesota – The sales factor includes *all* sales, gross earnings, or receipts received in the ordinary course of the business, *except* interest, dividends, sales of capital assets, sales of property used in the trade or business, and sales of stock and debt instruments.

New York – A treasury function receipt from the sale of a capital asset is not a business receipt and is not includable in the receipts factor. *New York* has not adopted UDIPTA.

The *Multistate Tax Commission* has adopted two regulations that accord the receipts described in this bill the same treatment.

Sales Of Other Than Tangible Property

Florida – In general, sales from intangibles are assigned to the state where the income producing activity is located. If the income producing activity is unknown, the sales are excluded from the sale factor. Sales from canned software are assigned to *Florida* if the customer is located in *Florida*.

Illinois, Massachusetts, New York, and Michigan assign sales of intangibles to the state where the income producing activity is located. If the income producing activity is located in more than one state, the sales are assigned to the state with the greater cost of performance.

Massachusetts assigns sales from prewritten software in the same manner as tangible personal property.

Minnesota – Sales from intangible assets are assigned to the state where the intangible property is used.

FISCAL IMPACT

This bill would not significantly impact the department’s costs.

ECONOMIC IMPACT

Estimated Revenue Impact of AB 1037 As Amended August 7, 2006 Assumed Enacted After June 30, 2006 Effective for Tax Years BOA Jan. 1, 2006 for Treasury Function Provisions and for Tax Years Beginning between Jan. 1, 2007 and Jan. 1, 2010 for Quadruple-Weighted Sales Factor Provision (\$ in Millions)					
	2006-07	2007-08	2008-09	2009-10	2010-11
Treasury Function:					
Net Gain	\$93	\$100	\$28	-\$36	-\$155
Business Income	24	30	32	32	35
Hedging	-2	-5	-5	-6	-5
Subtotal	\$115	\$125	\$55	-\$10	-\$125
Quadruple-Weighted Sales Factor	-\$25	-\$105	-\$155	-\$108	-\$13
Total	\$90	\$20	-\$100	-\$118	-\$138

Treasury Function

One component of the treasury function revenue estimate relates to limiting gross receipts from treasury function activities to net gains and reflects only a short-term cash flow gain. The reason for this is that the department assumes that its interpretation of the law relating to including "net gain" from treasury function activities in the sales factor is correct. Therefore, regardless of how taxpayers file, the use of "gross receipts" instead of "net gain" in the sales factor for the treasury function will ultimately be disallowed. The impact of this bill would be to provide certainty and to accelerate the cash flow. This revenue would, under this bill, come into the state during the fiscal year when the taxpayer makes estimated and final payments, as opposed to several years later after an audit has been completed and the administrative dispute resolution process is final.

The revenue impact of the treasury function issue relating to gross receipts in the sales factor is estimated in three steps. Because the treasury function issue is associated mostly with large, apportioning out-of-state corporations, all corporations that met the following conditions for the 2001 tax year were identified:

1. Taxable income greater than \$5 million,
2. Headquarters outside of California,
3. Income apportioned to California, and
4. Gross receipts (as reported on line 1C of Schedule F, Computation of Net Income, Form 100) are less than 90% of gross sales (the denominator of the sales factor as reported on Schedule R, Apportionment and Allocation of Income, Form 100).

About 300 corporations met the above conditions. The preliminary revenue impact of the proposed law is estimated by re-computing the tax liability using the new apportioning factor in which the denominator of the sales factor is replaced with gross receipts. Next, the top 50 of these corporations were evaluated using the department's tax audit cases to identify the revenue impact due to treasury function issues for each corporation. Finally, the result of this evaluation was adjusted upward to account for the remaining 250 corporations, including the corporations that did not include Schedule F or Schedule R with their tax returns. The 2001 revenue estimate is extrapolated into future years based on the 2006 May revise Department of Finance's projection of corporate profits.

There are currently four cases pertaining to the treasury function issue pending before the California Supreme Court.¹¹ A decision in two of the cases should be issued by the California Supreme Court before the end of August 2006. The other two cases have been deferred pending the decision of the two cases. The estimate presented above is based on an assumption that the FTB will prevail in both cases. Particularly in the case of Microsoft, if the court were to decide against the FTB, the anti-churn provision of this bill could have a more significant impact. The gain from the treasury function provision for 2006-07 would grow from \$93 million to about \$115 million. In 2007-08, the revenue gain would change from \$100 million to about \$125 million. In 2008-09, the revenue gain would change from \$28 million to about \$150 million. In 2009-10, the revenue impact would change from a loss of \$38 million to a gain of about \$150 million. In 2010-11, the revenue impact would change from a loss of \$155 million to a gain of about \$150 million.

A second component of the treasury function revenue estimate is the revenue impact from the amendment that would reclassify all nonbusiness income from a treasury function activity to business income. For tax year 2002, total nonbusiness income from treasury function activities was estimated to equal \$8.4 billion. Of this amount, \$190 million was allocated to California and subject to state tax. This bill would classify the \$8.4 billion of nonbusiness income from a treasury function activity to business income, and therefore, this amount would be subject to apportionment. Using an average apportionment percentage of 6.7 percent, the amount of nonbusiness income from treasury function activities that would be subject to California tax would be \$565 million (\$8.4 billion times 6.7%). If this bill becomes law, an additional \$375 million in nonbusiness income from treasury function activities would be subject to California taxation. (\$565 million less \$190 million). The amount of revenue gain would be \$22.5 million (\$375 million times 6% marginal tax rate) on a taxable year basis. The estimate at the 2002 level is grown to subsequent taxable years by the projected growth in corporate profits as forecasted by the Department of Finance and converted to fiscal numbers.

A third component of the treasury function activity relates to the amendment that removes hedging activities from the definition of a treasury function activity. This amendment is

¹¹ General Motors and Microsoft were argued on June 2, 2006. The Limited and Toy's "R" US have been granted review with briefing deferred pending a decision in the cases that have been argued.

estimated to result in short-term revenue losses as some taxpayers may take aggressive positions on reporting gross receipts from hedging activities.

These positions are estimated to result in less revenue collected in the short-term, but collected in later years after an audit has been completed and the administrative dispute resolution process is final. Based on discussions with the department's audit and legal staff regarding actual cases, it is estimated the short-term loss would be approximately - \$2 million in tax year 2006. This estimated loss is grown to subsequent taxable years by the projected growth in corporate profits as forecasted by the Department of Finance and offset against revenues collected in subsequent audits.

Three-Factor, Quadruple-Weighted Apportionment Formula¹²

For the proposed three-factor, quadruple-weighted apportionment formula, samples of corporate tax returns for the tax years 2002, 2003, and 2004 were used for this analysis. In the prior analysis of the bill as amended January 18, 2006, the tax returns used in the sample were 2001, 2002, 2003. For each corporation, tax liabilities under current and the proposed apportionment formulas were computed. The revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the above sampled tax years. The revenue impact was computed as the average of these three tax years; \$63 million for tax year 2002, \$111 million for 2003, and \$163 million for 2004, for an average revenue impact of \$112 million ($\$63 \text{ million} + \$111 \text{ million} + \$163 \text{ million} / 3$). The \$112 million was grown to \$135 million for the 2007 taxable year using the projected growth in corporate profits as forecasted by the Department of Finance. The estimated impact is assumed to grow at the same growth rate as corporate profits for future years. These taxable year numbers are then converted to fiscal year numbers.

LEGAL IMPACT

This bill would treat all treasury function income as apportionable business income subject to California tax. If treasury function income has no relationship to activities that occur in the state, this rule may be determined to violate the Commerce Clause of the United States Constitution. Taxpayers may argue that the Commerce Clause is violated because inclusion of the treasury function in apportionable business income is not rationally related to activities that take place in the state.

POLICY CONCERN

¹² Property, Payroll, and four times sales.

This bill would exclude a taxpayer's hedging activities, such as the purchase and sale of futures contracts relating to business activities, from the definition of the treasury function. This may allow taxpayers to decrease their California sales factor by including the gross receipts from these activities in the sales factor denominator. The issue of what constitutes a "gross receipt" from hedging activity as well as the distortive effect of the inclusion of these receipts at "gross" is already the subject of pending litigation.

LEGISLATIVE STAFF CONTACT

Gail Hall
Franchise Tax Board
(916) 845-6111
gail.hall@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov

Analyst: Gail Hall
Telephone#: 845-6111
Attorney: Patrick Kusiak

FRANCHISE TAX BOARD
AB 1037 As Amended August 7, 2006

AMENDMENT 1

On page 3, line 27, strikeout "Section 38006," and insert:
Section 38006 of Part 18 (commencing with Section 38001),

AMENDMENT 2

On page 4, line 7, strikeout "investment of liquid assets." and insert:

investment of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, including, but not limited to, providing a reserve for business contingencies and business acquisitions.

AMENDMENT 3

On page 4, revise lines 12 through 15 to read as follows:

(2)(A) "Liquid asset" means a readily marketable intangible, including, but not limited to, bonds, stocks, future contracts, debentures, options, warrants, foreign currency, ~~and~~ mutual funds that hold those intangibles, and repurchase arrangements relating to those intangibles. "Liquid asset" does not mean

AMENDMENT 4

On page 11, delete line 36, and insert:
be made on the

AMENDMENT 5

On page 12, delete line 31, and insert:
be made on the

APPENDIX A
(Principal Business Activity Codes Used In AB 1037 As Proposed August 3, 2006)

1. QUALIFIED TAXPAYER

Code	Description
312130	Wineries
325410	Pharmaceutical & Medicine Mfg
333200	Industrial Machinery Mfg (Semiconductor only)
334110	Computer & Peripheral Equipment Mfg
334200	Communications Equipment Mfg
334410	Semiconductor & Other Electronic Component Mfg
339110	Medical Equipment & Supplies Mfg
511210	Software Publishers
512100	Motion Picture & Video Industries (except video rental)
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming
517000	Telecommunications
713100	Amusement Parks & Arcades

2. MORE THAN \$1 BILLION OF GROSS BUSINESS RECEIPTS

Code	Description
312130	Wineries (Added)
325410	Pharmaceutical & Medicine Mfg (Added)
333200	Industrial Machinery Mfg (Semiconductor only) (Added)
334110	Computer & Peripheral Equipment Mfg (Added)
334200	Communications Equipment Mfg (Added)
334410	Semiconductor & Other Electronic Component Mfg (Added)
339110	Medical Equipment & Supplies Mfg (Added)
511210	Software Publishers (Added)
512100	Motion Picture & Video Industries (except video rental)
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming
517000	Telecommunications (Added)
713100	Amusement Parks & Arcades

3. MORE THAN 50% OF GROSS BUSINESS RECEIPTS

Code	Description
211110	Oil & Gas Extraction
221210	Natural Gas Distribution
324110	Petroleum Refineries (including integrated)
324190	Other Petroleum & Coal Products Mfg
424700	Petroleum & Petroleum Products
425120	Wholesale Trade Agents & Brokers
447100	Gasoline Stations (including convenience stores w/gas)
454312	Liquefied Petroleum Gas (Bottle Gas) Dealers
486000	Pipeline Transportation
523130	Commodity Contracts Dealing